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Reserve System the Banks

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Washington, D. C.

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THE FEDERAL RESERVE SYSTEM AND THE BANKS

UNIV. OF CALIFORNIA

HON. PAUL M. WARBURG

Member Federal Reserve Bank

Washington, D. C.

Address Before

THE NEW YORK STATE BANKERS'
ASSOCIATION CONVENTION
ATLANTIC CITY, NEW JERSEY
JUNE 9th, 1916

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MAIN

The Federal Reserve System and the Banks

A SUCCESSFUL solution of Federal Reserve problems is dependent equally upon a thorough understanding of the many features of detail involved in the technique of banking and upon a strong grasp of the big and fundamental objects for the accomplishment of which the system was created.

It is, therefore, a pleasure to address an audience that is certain to have a keen and sympathetic interest in both of these phases of the problem. I am particularly anxious, however, to speak to you about the broader and more fundamental questions involved, for there is an indefinite feeling of apprehension in my mind that at this time we may be losing the big point of view of financial statesmanship, and that petty and technical questions may be claiming, perhaps, too much of our consideration.

While in South America I had an opportunity to get a bird's-eye view of the operation of the Federal Reserve System. With the keenest enjoyment and pride I saw our system hitting its mark many thousands of miles away, and became deeply impressed that we are now firmly establishing ourselves as a great financial power in the world's market. Upon my return I felt a very chilling change of atmosphere, when I met American bankers appearing to hold the view that the future of our great monetary and banking system depends upon the question whether or not a country bank might charge

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exchange of one-tenth of one per cent when remitting for checks drawn on itself!

The banking system of a world power cannot possibly be construed upon so small a foundation.

I still remember that, when I had my first training in banking in Hamburg, thirty years ago, my dear old father's mind strongly rebelled against what he considered then the new-fashioned idea of being required—not by the government, indeed, but by the general law of competition—to discontinue the practice of charging a small commission when remitting for checks or maturing bills drawn on his banking firm. But he soon perceived that the establishment of a general transfer and clearing system, postal orders and postal checks, had made for new conditions and that the development of a discount system based upon modern principles of banking, while breaking down certain petty revenues, was bringing about a tremendous increase in the volume of business. As a result, he soon waived his objections and lent his hand in turning his country from provincialism into an international banking power. That, as I said, was thirty years ago.

I have no doubt that this country has decided that it is entitled to as modern a banking system as the rest of the world, and that whatever old-fashioned privilege still blocks the path will have to fall by the wayside. The sacrifice will have to be borne for the general good and will find its compensation in the freer economic development of the country.

American Bankers' Acceptances

One of the most tangible results of the operation of the Federal Reserve System is the establishment and growth of the American bankers' acceptance business. In addressing a group of bankers it is unnecessary to dwell at length upon the fundamental importance of this development for the general safety of our banking system. We

have now a substantial market for bankers' acceptances to which all member banks will look for the investment of some of their idle means and in which, at any time, they may reconvert these holdings into liquid funds.

The more important this market grows, the stronger will be the position of the Federal Reserve Banks, for the greater or lesser volume of purchases of such acceptances will offer one of the Federal Reserve Banks' most effective means of exercising a wholesome influence upon the fluctuation of interest rates. As normal conditions are re-established in the world, this acceptance market will become an important factor in protecting our exchange position with foreign countries and, incidentally, our gold holdings. It has taken some time to develop this market, but I am confident that, from now on, its growth will be rapid. One of the obstacles that made the start difficult was found in the fact that many acceptauces, which are made for the purpose of financing importations and exportations, have to be drawn and sold in foreign countries.

Branches in Foreign Countries

In order to make them negotiable in those countries as a popular and current means of exchange, it was first necessary to find banks there which would be willing to purchase them freely whenever offered. It is unnecessary to say that European banks operating in these foreign fields were not over-anxious to see American bankers enter a business which they themselves monopolized up to the beginning of this war. It is only since our own banks went out into foreign lands and established their own branches that the necessary foreign market for American acceptances has been developed. The establishment of foreign branches of American banks has been a most important step in advance, and without it our acceptance system could not have progressed as far as it has today. The advent of these American branches

forced the other banks to modify their resistance and to compete for our bills which, up to that time, they had tried to disregard. It is to be hoped that other American banks will soon follow in establishing themselves in foreign countries.

Banks Organized to do Business in Foreign Countries

As you know, the Federal Reserve Board has recommended an amendment to the Act to enable national banks, singly or jointly, to hold stock in banks organized "principally to do business in foreign countries." One bill has already passed the House, and another has been reported favorably by the Senate committee on banking and currency. The Board hopes that a satisfactory bill will be agreed upon by both houses in the very near future.

Use of American Credit Facilities as Against Foreign

It is a strange fact, however, that many of our business men, who enjoy the reputation of being keen and progressive, are actually wasting their funds by still using foreign acceptance credits instead of American. At Rio I found to my surprise that the majority of American coffee importers were still using letters of credit in sterling for which they were paying a discount rate of about 4¾% as against the American discount rate of 2%. Moreover, in doing so, they were often paying two commissions, one to the foreign banker who issues, and one to the American banker who opens the credit, instead of paying a single commission to the American banker.

It is true that the wool and hide business, done by New England with the Argentine, is today financed by dollar acceptances drawn on Boston and New York, and that the oriental trade has begun to use dollar bills, but it is surprising that so large a number of New York importers are still clinging to their old pound sterling acceptance arrangements.

Let me venture to urge most earnestly that our bank-

ers canvass their lists of importing and exporting firms and point out to them the folly of not using American banking facilities. Since my return I have tried to see personally some of these large importing firms and explain to them the anomaly of their action. I believe, however, that an association like yours is particularly well adapted for carrying on a campaign of education of this kind.

With our increasing financial strength and with the daily diminution of Europe's saving power, it stands to reason that, for a long time to come, our discount rates will compare favorably with those of Europe. We may expect, therefore, that this acceptance business will not only hold its own, but will grow and may be used to a substantial extent even by European importers and exporters, and thus relieve Europe of some of her financial burdens.

While our foreign competitors, with few noteworthy exceptions, are still trying to keep our dollar acceptances in obscurity, our machinery is now firmly organized. There are now local banks almost everywhere abroad willing to buy American drafts going forward for acceptance and to deal in dollar exchange on practically the same narrow margin which prevails in dealings in sterling, marks, or francs, and the Federal Reserve Banks are willing, whenever desired, to do their share by quoting favorable "forward discount rates" to assure the rate of discount pending the time of transit. This new feature of American banking, which is to be one of the roots of our strength and, at the same time, a new source of profitable and sound banking, ought to be developed energetically by both our bankers and our business men.

Recommendations of Conference of International High Commission at Buenos Aires

In this connection, it may not be amiss to give you a short account of the conference of the International High Commission at Buenos Aires.

In our deliberations, the question of banking was given particular attention, and I am happy to report that the general tendency at the conference was to do everything possible to foster trade relations between the United States and her neighbors to the South, and mutually to open the doors wide to one another's banks. Resolutions were passed making for the adoption by Central and South America of uniform laws concerning bills of exchange, bills of lading, warehouse receipts, and similar matters. A further recommendation was adopted by the conference urging the respective governments to enact legislation giving the widest possible protection to the sellers of goods.

You are all familiar with the agreements for the arbitration of business disputes made between the United States Chamber of Commerce and the Chamber of Commerce of Buenos Aires. We may expect that other countries will follow in the very near future, and the creation of these agreements will be an important factor in obviating the annoyance and delay of protracted litigation in foreign countries and in providing for both sides a safe and satisfactory basis for commerce and trade.

Uniform Money of Account

It would lead too far to enumerate all the topics discussed by the conference. I should not omit, however, to mention that a resolution was passed recommending that all the republics of North, Central and South America adopt a uniform standard of money of account on the basis of a gold coin 9/10 fine and weighing 0.33437 gramme. This unit, which might be called the Pan-American franc, though nearly the value of the European franc, is not its exact equal, but is precisely one-fifth of the United States gold dollar. Delegates to the conference had suggested making the gold dollar of the United States the unit for all American countries, but against this it was pointed out that the dollar would be

too large a denomination for many of the Southern republics, where small coins circulate and where, it was feared, the larger unit of money of account would bring about an increased cost of living. Moreover, the United States gold dollar could not be divided into subsidiary coins small enough to comply with the known demands of many of these countries. It was thought, therefore, that a unit of the approximate size of the franc would be better adapted to the needs of these countries, but, by adopting as the standard unit the exact one-fifth of the United States dollar, the foundation will have been laid for a Pan-American union of coins which, sooner or later, may become of great importance. If this plan should be carried into actual effect, the Pan-American 20 franc piece could ultimately circulate with us as a $4 gold piece and our $5 gold piece could circulate as a 25 franc piece in South or Central American countries. A unity of standards of this kind will, of course, have great advantages in facilitating trade between nations. Amongst republics having actually introduced a gold currency on this basis it might ultimately lead to an understanding for the establishment of international gold trust or clearing funds, having for their object the elimination of the costs and risks caused by our present wasteful method of shipping and remelting gold coins. A plan on these broad lines, submitted by the American delegates, was recommended by the conference for closer study to all governments concerned.

The immediate practical importance of this step may not be great. As indicative of the trend of future relations between North and South American republics, however, it cannot be overestimated. It shows, as one of the effects of the war and of our financial emancipation, that the North and South have recognized their common economic and political interests; that they have begun to consider this large hemisphere as one economic unit, and

that they are now looking to each other for mutual help and co-operation in the future development of their respective problems. A Pan-American monetary union, therefore, now appears a more natural basis for the future monetary systems of American republics than a Latin union based upon an agreement with France, Italy, Switzerland and Belgium.

Our friends in South America consider the creation of our Federal Reserve System as one of our greatest achievements, and their willingness to rely upon our ability to provide—to a certain extent at least—such financial aid as Europe gave them in the past is predicated upon the confidence that our new system inspires. Some of these republics are carefully studying this system with a view to establishing, at the proper time, a similar banking machinery. In view of the fact that several of these countries are federations like the United States and cover tremendous areas of territory, it is evident that certain features of our system would be particularly well adapted to their needs.

Legislative Handicap in the Past

While observing financial and commercial conditions in these countries, it was deeply impressed upon my mind how much the United States, by legislative action, had in the past handicapped the development of our business in foreign lands. It would lead too far to mention to what extent our own legislation in the past has driven our merchant marine from the ocean and how far it has handicapped our industries by not permitting reasonable trade combinations enabling us to compete in foreign markets. But it is well within the bounds of this address to mention that the British, French and German banks for generations have been entirely free to go into foreign countries to open branches or acquire foreign banks and to do everything and anything to further their banking and trade. On the other hand, our national

banks, until the passage of the Federal Reserve Act, were forbidden by law to enter these fields or to accept drafts for importations or exportations or to exercise many other functions necessary to develop foreign banking and foreign commerce. It is a relief to feel that at last the time has come when a clear recognition of our country's banking needs is asserting itself and when most of these old shackles have been removed. Whatever obstacle remains we may confidently hope to see gradually eliminated.

Amendments to Federal Reserve Act

Some amendments along these lines are at present under consideration by Congress, and have already been favorably reported.

Three months bankers' drafts

The Board has recommended that Congress permit member banks to give their acceptances not only for the financing of transactions involving importations and exportations, but also, to a limited degree and under the supervision of the Federal Reserve Board, for bankers' clean three months' drafts, such as are required in foreign countries for remittances abroad. As most of you know, in South America, such remittances to foreign lands are generally not made by checks, but by three months' drafts, and it is necessary that national banks be permitted to accept for this kind of foreign exchange transactions, if the dollar bill is to be used as freely in foreign lands as is the sterling, the franc, and the mark exchange.

Domestic Acceptances

Turning to amendments touching domestic operations, we have recommended that national banks be permitted to accept drafts or bills growing out of transactions involving the domestic shipment of goods—provided shipping documents are attached at the time of acceptance—and drafts and bills which are secured by warehouse or similar receipts covering readily marketable staples, or by the pledge of goods actualy sold. We feel confident

that, by enlarging the powers of national banks to accept in this manner, we shall open for our member banks a new and profitable field of operation, and incidentally the free development of this kind of bankers' domestic acceptances will be an important factor in equalizing interest rates in the various parts of the country and will be of great benefit in this respect alike to producer and consumer.

Branches within city limits

We have also proposed an amendment authorizing any national bank, located in a city of more than 100,000 inhabitants and possessing a capital and surplus of $1,000,000 or more, to establish branches within the corporate limits of its city, and authorizing any national bank located in any other place, with the approval of the Federal Reserve Board, to establish branches within the limits of its county or within a radius of 25 miles of its banking house, irrespective of county lines. In recommending the county line for branches, the Board was moved by the thought that it might be found convenient for several small banks doing business in the same county to combine into one larger bank, thereby reducing the overhead charges and making the deposits of one part of the county available for the demands in another. It is the hope of the Board that in some districts, through such co-operation, it will be possible to reduce the exorbitant interest rates which, in some instances, have been charged by small country banks. The Senate committee has stipulated that, for the beginning at least, the number of branches of a national bank shall be restricted to ten.

Branches within county limits, etc.

Loans on improved real estate

We have further recommended to Congress that any national bank, not situated in a central reserve city, be permitted, within the same limits now existing for loans on farm lands, to make advances maturing in not over one year on improved real estate located anywhere with-

in a radius of one hundred miles of its place of business. While the Board does not favor the idea of having national banks make heavy investments in mortgages, it was felt that they should not be precluded from taking, within certain reasonable limits, first mortgages as collateral security for their loans.

Short advances to member banks

These are the additional powers that we have recommended to be given to national banks. As to the Federal Reserve Banks, we have suggested that Congress permit them to make advances to their member banks on the latter's own notes secured by eligible paper, such loans to be for periods not exceeding fifteen days. This has been done with a view to enabling Federal Reserve Banks to accommodate members who, in the check clearing or otherwise, might be short in their balances and wish to have short advances at moderate rates. We believe that this power, if granted to Federal Reserve Banks, will greatly increase their ability to take care, in a simple and effective manner, of the requirements of their members, and particularly of country banks.

Issue of Federal Reserve Notes against gold

We have further recommended that Congress permit Federal Reserve Banks to issue Federal Reserve notes, not only against commercial paper, but also against the deposit of gold. This amendment, if granted, would greatly strengthen the lending power and the note issuing power of Federal Reserve Banks. It is the same method that has been followed in Europe by the Banque de France, the Reichsbank, the Bank of the Netherlands, the Bank of Italy and many other government banks. These institutions are enabled, through their note issue, to assemble a large part of the gold of the country in a central reservoir. With us, up to the present time. this accumulation of gold has taken place to only a moderate extent and has not benefited the Federal Reserve Banks to the fullest possible degree. If the

amendment were to be passed, the gold, instead of being segregated with the Federal Reserve Agent, would remain an asset of the Federal Reserve Bank, and, on the other hand, the notes issued against it, instead of being, as at present, technically redeemed, would remain the liability of the Federal Reserve Bank.

In case the amendment should pass, it is hoped that the Federal Reserve Banks may count upon the co-operation of their members in order to facilitate this substitution of Federal Reserve notes for gold certificates at present carried in the pockets of the people in the old-fashioned and uneconomic manner. As in modern European countries. the gold should accumulate in the Federal Reserve Banks and the people should use instead the Federal Reserve notes. The amendment would be an important step in the ultimate simplification and consolidation of our circulation.

These are the principal amendments recommended by the Board at this time. You will notice, gentlemen, that they move in two directions. The one is an increase of the Reserve Bank's general strength and lending power and an enlargement of their scope of usefulness in dealing with their members; the other is the removal of limitations heretofore placed upon the operations of national banks.

Broadening of powers but no lowering of banking standard

The Board feels keenly that, as a matter of equity, national banks should be placed on a parity with State banks and trust companies, wherever this can be done consistently with safety and conservative banking principles. But I wish to make it clear that the Board has recommended, and will recommend, only such measures as will eliminate old-fashioned or unwise restrictions such as should be removed under any circumstances, irrespective of whether or not the State banks exercise greater or lesser powers. The Board would never recom-

mend granting national banks any powers or privileges which are contrary to good banking principles. It is to the interest of both State institutions and national banks that banking standards should be raised wherever practicable and not that they should be lowered. Between the national and State banking systems there must not be any competition to secure more members by a lowering of banking standards. The whole country would suffer if this took place. It would be the height of folly if States were to lower their requirements for no other reason than to underbid the requirements of national banks. To a certain degree this has been done—where State governments lowered the reserve requirements for their banking institutions because the Federal Reserve Act lowered the reserve requirements for national banks. The lowering of the reserve requirements for national banks was predicated, however, upon their joining the Federal Reserve System, subscribing to the stock, and putting some part of their reserves into the joint insurance fund, and being bound ultimately to abandon the method of pyramiding reserves and to keep them instead either entirely in metallic form or with the Federal Reserve Banks. The reserves of State institutions, on the other hand, were lowered without their being required to join the system, make any such contribution, or discontinne pyramiding reserves. Moreover, lower reserve requirements are justified for member banks because they may have direct recourse to the rediscount facilities of the reserve system, but non-member banks have no such direct access.

I wish I could adequately impress upon the minds of all our bankers that there is no such thing as doing anything *for* the Federal Reserve System. Whatever the member banks do, and whatever the State banks do, they do for themselves and for the country. The Federal Reserve System, as such, is not a self-seeking and profit-

making organization. It belongs to the entire country. It is there for the benefit of everybody; for the greater security of the banks, and, through the banks, for the security of the people. If you strengthen the Federal Reserve System, you strengthen yourselves. If you raise the standard of banking, it is for your own benefit—not for the benefit of the Federal Reserve Banks, or least of all, for that of the Federal Reserve Board.

These things appear trite, but still I cannot help expressing them because it is so absolutely essential that the thought be overcome that there can be such a thing as a conflict of interests between the Federal Reserve System and the banks. The Federal Reserve System and all it means is felt as an opposing factor where it comes into conflict with bad banking practices. It is true that the law has for one of its objects the removal of certain habits which have crept into the old banking system, but it is equally true that, by removing them, financial catastrophes such as used to befall our country with uncanny regularity, are to be avoided in the future.

Pyramiding of Reserves

Let us consider, as the strongest case in point, the pyramiding of reserves. I wish it had been possible to stamp out this evil within a short time after the opening of the Federal Reserve System. As it is, many of the smaller banks are still in the condition of a patient who knows that he must undergo an operation in order to be fully cured, but whose mind every now and then rebels at the thought, and who continually relapses into arguing with himself that, after all, he might possibly prefer to continue to live with his disease and take his chances of the certain recurrence of acute convulsions and intense suffering rather than to have the operation performed. The country, however, has decided that the operation is necessary for our future safety and growth, and the vast majority of our bankers are in full accord that it is the

wisest thing to do. The pyramiding of reserves will thus end on November 16, 1917. But, as I said, I wish the operation had already been performed.

Analysis of present reserve situation

At present our national banks apparently have excess reserves approaching one billion dollars. Of these, a substantial proportion represents items in transit between the depositing and the depository banks; the balance, excepting about $100,000,000 excess cash in vault held by all national banks outside of New York, is kept entirely in central reserve cities, the bulk being in the City of New York. There it is on deposit—drawing interest at the rate of 2%—and loaned out on stock exchange and other collateral, or invested in commercial paper, except as to the required reserve of 18% and the small total excess reserve of about fifty million dollars. This is a reduction of excess cash reserves in New York of over $100,000,000 since January 22d.

If Farmer Jones deposits $1,000 in a bank of Elk River, Minnesota, and this bank should in turn deposit this amount in a bank at Minneapolis and the Minneapolis bank in turn deposit it in New York at 2% interest, and New York invest this money in a piece of commercial paper at 3% interest, it is a most extraordinary and unique method to permit Elk River and Minneapolis to count these deposits as reserves, while if the bank of Elk River had itself bought the piece of paper it would have carried it as a loan and all the rest of the structure of reserve bank deposits and reserves would have been wiped out.

In other words, in the final analysis, if we consider the system as a unit, there is not an excess reserve of one billion, but only about $150,000,000 in cash; the balance is invested today in the "float," representing uncollected items in transit, commercial paper, stock exchange loans and securities. If we study the changes in the condition

of the New York Clearing House national banks which have occurred between October 31, 1914, and May 1, 1916, we find the following increases estimated at:

(In millions of dollars)

	Oct. 31, 1914.	May 11, 1916.	Increase.
Collateral loans	547	954	407
Investments in securities	106	280	174
Unsecured loans, which includes commercial paper....	406	667	261
Total			842
During that period deposits increased from	1,200	2,100	900

In addition, collateral loans and holdings of securities of New York non-member trust companies increased by about half a billion since the end of 1914.

These are phenomenal increases and we might well ask ourselves whether or not we may take it as a certainty that so extraordinary a growth will prove to have come to stay or whether a return of more nearly normal conditions will not bring about a contraction. We should well consider this question, because an increase of 90% in securities and collateral loans—that is, an increase of over $1,000,000,000 in New York City Clearing House institutions—might well suggest a policy of liquidation rather than one of further expansion. Our national bank *cash* reserves in central reserve cities (including balances with Federal Reserves Banks, figured at 100%) were as of March 7, 22.88%; in reserves cities, 11.53%, and in country banks, 9.80%.* Notwithstanding that the aggregate cash held by all national banks increased

*If we figured these balances at 70%, being the present cash reserve condition, and the actual metallic reserve, and added to cash in vault the metallic cover maintained against reserve agents balances, the present cash cover would show as follows: Central reserve, 20.51%; reserve cities, 13.66%, and country banks, 11.83%.

from May, 1915, to March, 1916, by over $100,000,000, in central reserve cities we are today materially below the old cash reserve requirements, and if a situation like the present had existed during any ante-Federal Reserve System period, we should have considered it a cause for alarm. Thanks to the creation of our new banking system, we are now dealing with completely changed conditions, and the spectre of the end of the lending power of the banks would not mean a panic as in the past because of the reserve lending power of the Federal Reserve Banks and the confidence created by their existence. But, gentlemen, that must not lead us into the illusion that this billion of so-called excess reserves may be considered as a basis for a loan expansion of four billion dollars or more, as appears to be the general belief. Theoretically there is the foundation for so large an expansion as long as we adhere to the old custom of counting bank balances with reserve agents and uncollected items in transit as reserve, yet, in the last analysis, it is the metallic cover—not the redeposited and actually invested reserves—which must be considered in dealing with this question of expansion of loans. *The excess of our metallic reserve, plus the free gold of the Federal Reserve banks, constitute the basis of the reserve lending power of our country.*

No basis for 4 billion loan expansion

We are at present in a condition of extraordinary strength. We have bought back our own securities and made foreign loans to an aggregate amount far in excess of $2,000,000,000. Our financial position for the future has thus been greatly fortified. *But the process of absorption of our securities returning from abroad should be conducted on such basis and scope as to turn the individual depositor into an investor, so as to free our gold reserves, rather than increase our loans on an enlarged floating supply of securities.*

Our opportunities limited by our control of gold.

We must not forget for a moment that not even the most experienced can foretell what demands may be made upon us in the future. At the end of the war our opportunities will be gigantic, but ultimately they will be limited by the extent to which we are able to control our gold. There cannot be any doubt that the demand for gold at that time will be very keen and determined. Wise statesmanship, to my mind, therefore, would indicate that everything should be done by the Federal Reserve System and by all the banks that are interested in our strength to watch carefully further expansion at this time and to accumulate the floating gold supply in the hands of the Federal Reserve Banks so as to enable them, when the time comes, if necessary, to spare large amounts without thereby crippling their lending power. We are in a period of widespread prosperity at this time and it must be our serious concern not to weaken its solid foundation. The ease of this summer might well be used to strengthen and prepare ourselves for the large problems that may be in store for us.

It is impossible to try to prognosticate with any degree of certainty what will be the trend of interest rates at the end of the war, but assuming that interest rates for invesments in Europe will be high, and that the demand for gold on the part of Europe will be keen, we would have to expect as a consequence that eventually our rates will have to move up so as to approach theirs more closely, and before we reach that point probably a substantial amount of our gold will have to leave the country and return to foreign lands. To preserve the advantage of our strength and to maintain our money rates on an independent basis of our own—in spite of the close inter-relation that must exist between us and Europe—will be one of our interesting but difficult tasks.

The establishment of the Federal Reserve System has

been a step of inestimable value in the direction of efficient control of our country's gold holdings; and, if we do not disregard all rules of business conservatism and prudence, it will prove an efficient means of protection in case of emergencies.

If we want more than a strong instrument of defense and protection, if we desire—as we are entitled to—that the Federal Reserve System be the foundation of a banking structure contributing its full share in rebuilding the world and at the same time assisting our own country to meet all the new demands, whether domestic or foreign, that the future may make upon it, then we must do all we can to preserve its strength and to broaden its foundation by further perfecting methods of systematically accumulating and economically using our vast treasure of gold. Too large a proportion of this gold still remains wastefully scattered and decentralized.

The gold stock of this country is estimated at $2,320,000,000. Of this amount, only $335,000,000 is held in the vaults of the Federal Reserve Banks and about $180,000,000 is in the hands of the Federal Reserve Agents. The national banks and State institutions hold about $800,000,000. and there is estimated to be in actual circulation about $870,000,000. If we deduct from the $335,000,000 held by all Federal Reserve Banks a minimum reserve of only 40%, that would leave as their free gold about $200,000,000. This is an invaluable item of strength as a basis for a note isue of $500,000,000 in case additional currency should be demanded by our people; and the Board, by permitting a reduction of the 40% gold reserve, could, in case of emergency, sanction the issue of even larger amounts. When, however, it comes to exportations of gold, you can readily see that the $180,000,000 now accumulated with the Federal Reserve Agents would serve as a very welcome additional pro-

tection. For we have learned, gentlemen, that this is a period of economic history, where balances between nations are not dealt with in millions, but in hundreds of millions.

Think of the strength that our system might possess if we carried into effect the policies pursued by the Banque de France, the Reichsbank or other powerful central banks, and if, for a substantial part of the $870,000,000 of actual gold circulation, there were substituted our Federal Reserve notes, and if national and State banks kept in their vaults only what they needed for till money and deposited with the Federal Reserve Banks the rest of their idle gold.

We talk of preparedness as the need of the hour. If we contemplate what European nations have done, before and during the war, to strengthen their grip on their gold, and compare it with our own efforts, we find that our financial preparedness is just in its first stages. The amendment recommended by the Board should prove an important step in advance in this direction.

Increased lending power no inflation

In view of the statement made by some of our critics that this substitution of Federal Reserve notes for gold certificates means inflation, it might be timely to point out that, by a simple substitution of one note for the other, there is, of course, no increase in the volume of circulation whatsoever. It is merely a change in the form of circulation. As a matter of fact, we find that the operation of all Federal Reserve Banks during a period of one and a half years has caused a net increase in the circulating medium of the country, by the issue of Federal Reserve notes and Federal Reserve Bank notes, of less than $10,000,000. On the other hand, the national bank circulation has decreased during the period November 2, 1914, to June 1, 1916, by $53,000,000, exclusive of the redemption of the approximately $385,000,000 of

emergency currency issued under the so-called Aldrich-Vreeland Act. While it is evident, therefore, that the Federal Reserve System has not increased the volume of circulation, the process of substituting, as a means of circulation, the Federal Reserve note for the gold certificate has the most important effect of strengthening the potential lending and note issuing power of Federal Reserve Banks in case of need. To refuse this larger power of protection for fear that it might be misused would be tantamount to refusing to give a modern revolver to a policeman for fear that he might shoot at the wrong man and at the wrong time.

Future reserve requirements

But, let me ask you, gentlemen, is this the proper time for country bankers to urge us to recommend to Congress the further reduction of their reserve requirements or to recommend that they be granted permission to continue to hold a certain percentage of their reserves with their central or reserve city correspondents?

Some day, no doubt, it will be proper to reduce reserve requirements, but that can only be brought about by a systematic strengthening of the central reservoirs. The stronger the Federal Reserve Banks, the easier the access to their resources by sale of liquid paper, the less will become the necessity for member banks to maintain in their own vaults, as a legal requirement, large segregated gold holdings.

Steps in this direction are: first, the substitution of Federal Reserve notes for the gold circulation in the pockets of the people; second, the maintenance with Federal Reserve Banks of larger member banks' balances, created by depositing part of the "optional" now kept in vault by member banks, and, finally, the increase of the number of depositors to be secured through the entrance of the State institutions into our system.

State banks and trust companies

I want to compliment our large member trust companies and State banks upon the broad point of view which guided them when entering the system; but I might at the same time ask their powerful sister institutions how, under present conditions, they can justify themselves in staying out of the system and in throwing the entire responsibility and burden upon the shoulders of the national banks and those few trust companies and State banks that have become members? They do not contribute their fair share of gold to the general reserve fund of the nation, nor do they provide their share of the capital of the Federal Reserve Banks. Indeed, not only do they fail to contribute their share of strength to the system, but, unconsciously perhaps, they become forces that make for the direct weakening of its strength and efficiency.

Do the large trust companies and State banks claim that pyramiding of reserves is sound? Would they prefer to see our ancient system perpetuated and the reforms contemplated by the Federal Reserve Act abandoned so as to make room again for the good old conditions of 1893 and 1907? Unless they are willing to subscribe to that doctrine, how can these large banking institutions, some located in Central Reserve cities, justify themselves in considering as reserve, after the manner of the country banks, their interest bearing deposits with other banks?

If a call loan on the stock exchange made by a trust company is not a reserve but a loan, is it sound banking to call a reserve deposit made by a trust company in a national bank a reserve, when 82% of it is loan on call on the stock exchange? Still, it is just through these deposits that, in emergencies, the trust companies will lean on the national banks and the national banks, in turn, will fall back on the Federal Reserve System. The net

result is that the trust companies, in building up their business structure, must rely today on the greater assurance provided by the Federal Reserve System, though permitting the member banks to carry the entire burden of its support. Our small country banks will have to stop pyramiding of reserves; do the large trust companies and State banks plan to continue this practice?

What is it that powerful and prominent institutions (some of which, in their foreign and acceptance business, derive the greatest possible advantage from the discount market and the general prestige of the Federal Reserve System) may say in justification of such an attitude?

Objections and Answers

At first they feared that, by entering the system, they might lose some of their present powers and privileges. But the Board has made regulations permitting them to continue to exercise practically all legitimate banking functions enjoyed by them in the past.

Dividends of Federal Reserve Banks

Some of the State institutions have raised the point that, by joining the Federal Reserve System, they would be called upon to make investments in the stock of the Federal Reserve Banks upon which, in the case of most of the Federal Reserve Banks, no return has as yet been paid.

But, gentlemen, while for many reasons some of us would favor an amendment permitting a Federal Reserve Bank to pay back a portion of the capital paid in (leaving the liability upon the subscribed but unpaid capital otherwise unchanged), provided the member would in turn agree to increase its required reserve balance by a certain proportion of its optional balance, this question in itself cannot possibly be of sufficient importance to keep any strong State institution out of the system. These dividends are cumulative, and anybody having a moderate degree of foresight can readily appreciate that,

sooner or later, the back dividends will all be paid. Even at the present low rate of return of 2.4%, secured by Federal Reserve Banks from their investments, they would have to employ only an additional sum of less than $50,000,000 for the entire system to earn the full six per cent on the stock at present paid in. When the final instalment of reserves has been transferred and with the return of more nearly normal rates of interest, there will not be the least difficulty for these banks to earn their dividends without investing a larger proportion of their resources than would be consistent with safety and conservatism.

Right of State banks to withdraw

State banks and trust companies furthermore claimed that if they entered they could not withdraw. But the Board, in the exercise of its power to prescribe regulations as a condition of membership, has provided that they may withdraw under conditions previously made known, and the subscription to the stock of a Federal Reserve Bank made by a State institution is conditioned upon this express agreement.

No examination by Comptroller

They have objected to being examined both by their own banking department and by the examiner of the Comptroller of the Currency. The Board, in accordance with the provisions of the Federal Reserve Act, has provided, however, that, wherever there is an efficient State examination, as in New York, it shall be accepted in place of examination by the Comptroller and, only failing that, an examination shall be made by examiners under the supervision of the Federal Reserve Board.

Furthermore, in a circular letter sent to all State member banks in May of this year, the Board and the Comptroller of the Currency announced that State member banks, in making their stated reports to the Comptroller of the Currency, might use the form of statement prescribed by their respective State banking depart-

ments, provided they are rendered as of the same date as required by the Comptroller of the Currency for national banks. If reports are not rendered on those dates, State member banks are required to use the same forms as national banks, but they may omit from their reports to the Comptroller all schedules except that relating to coin or coin certificates.

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They have feared that the Clayton Act would deprive them of valuable directors. But Congress has amended that Act so as to permit a director of a member bank to be, at the same time, a director of two other banks or trust companies, provided they are not in "substantial competition" with the member bank.

I know the arguments that are being advanced that the rulings of the Board may be changed and that, therefore, it may be possible, under a different personnel of the Board, to reverse the present arrangement and subject the State banks to the examinations, reports, and rulings of the Comptroller of the Currency. But that is not likely to happen, and if it did, the State bank or trust company could exercise its privilege to withdraw from membership in the system.

Let us assume, however, that joining the Federal Reserve System does involve certain sacrifices, some of which are necessary and some of which may be thought unnecessary. If you throw into one side of the scales all the benefits accruing to the banks and the nation by the creation of the Federal Reserve System, and into the other the sacrifices to be made by its members, there cannot be any doubt whatsoever that the advantages will outweigh the disadvantages a thousandfold. The Federal Reserve Act is one of the most constructive pieces of legislation that ever was put upon our statute books. Nobody could be foolish enough to expect that a law

which is so complicated in its nature, so far-reaching in its scope, and a compromise in so many details between opposing views, could be absolutely perfect. It is a wonder that, from the beginning, it has proved as workable as it has.

Personally, I am on record as having opposed several of its features of detail. But, when the President honored me by inviting me to become a member of the Board, I accepted because I felt that the fundamental principles were sound and that the Act, as it stood, would redound to the greatest benefit of the country. I felt confident that if after sincere and unbiased efforts in the operation of the Reserve Banks, defects should develop that needed correction, we could confidently count on a patient and sympathetic hearing before Congress. And let me remind you, gentlemen, that several of my colleagues and the able men who accepted to serve at the head of your Federal Reserve Bank of New York, all joined in the same spirit; they did so for the purpose of serving their country even though they had to make material sacrifices in doing so.

Contribution by all essential to success

In one of his admirable speeches, entitled "Ideals and Doubts," Oliver Wendell Holmes, Associate Justice of the Supreme Court of the United States, makes the following statement concerning the topic of legal reform:

> "To know what you want and why you think that such a measure will help it is the first but by no means the last step towards intelligent legal reform. The other and more difficult one is to realize what you must give up to get it, and to consider whether you are ready to pay the price."

These are golden words of wisdom which, at the present juncture of our economic history, every bank president in the United States ought to have constantly before his eyes.

For generations we have lived shackled and constantly menaced by a defective and old-fashioned banking system; for years we have toiled to secure reform. We have at last brought it about and, whether or not it pleases everybody in every detail, it behooves us all to do our share in making it a success for the greatest possible benefit of our country, no matter whether it involves some small or even a heavy sacrifice. That is the principle which members of the Board have laid down for themselves, and if they are to be faithful to their trust and successful in their task, there is no other principle upon which they can deal with the banks of the country.

Exchange charges by country banks

That is why, though sincerely appreciating the hardship it entails for the country banker, and fully sympathizing with the difficulties of his position, we must say to him: "Forget these exchange charges. We think our new clearing plan is fair and equitable, free from unsound principles and bound to become a very effective instrument for the general good. It offers to take from you at par all your checks on any member bank of the entire United States, and on certain State banks in addition, and will refund you any actual expense that you may incur in case you have to remit currency. All it asks of you in return is that you remit without charge to your Federal Reserve Bank in payment of checks drawn on yourself. But even if we did not believe that, by the service we render and by relieving you of the necessity of maintaining bank balances all over the country, we shall compensate you for what you think will be your loss, we have to hold to the view that you must pay the price—whatever your little share may be—for the larger benefit of all."

New opportunities

The new system brings new opportunities; as an illustration, let me remind the country banker that his exchange loss will appear to him very unimportant if he

will adopt the habit of paying for his deposits a fluctuating rate of interest, which should always remain a certain percentage below the ninety-day discount rate of his Federal Reserve Bank. The unreasonable rates paid for deposit money are a serious menace to the safety of our banking system and the economic development of our country.

Message to State Banks and Trust Companies

And, with this same spirit, and even with greater emphasis, we must say to the State banks and trust companies:

At this momentous period of its financial history, the country is entitled to have its banking system attain its maximum strength. Irrespective of burdens involved—imaginary or real—it is the duty especially of these large State institutions to come in promptly and contribute their share, making whatever suggestions they think helpful as friends and members rather than as critics from the outside.

I am glad to state that one of our largest trust companies expressed precisely this broad point of view when applying for membership.

The Federal Reserve System will grow stronger with every coming day, and the stronger it grows and the more it perfects its organization, the more apparent will its benefits become for all its members. A great deal of pressure has been brought to bear upon the Federal Reserve Board, particularly during the early stages of the development of American bankers' acceptances, to cause discrimination against the acceptances of non-member banks. So far the Board has been disinclined to favor such a policy, as it was thought to be in the general interest of the country to give encouragement to the freest and fullest development of this acceptance business, which is of the greatest benefit to the trade of

our country. The Board thought further that time should be given to the State banks and trust companies to acquaint themselves fully with the policies to be pursued both in dealing with State institutions in general and the acceptance business in particular. Nor does the collection plan just approved by the Federal Reserve Board contain any element of discrimination against non-member State banks collecting at par, without cost, their out of town checks through member banks of the system. The Board believes, however, that the time has now come for these large institutions to recognize their duty to join the system. It will not be long before the banks that stay out of the system will become conscious of the fact that member banks will command the greater confidence, and there is no doubt that the public will begin to resent having its interests sacrificed for the benefit of institutions unwilling to join the general protective system, and that before long their resentment will have to be heeded.

Before closing, I should like to make it clear that, though speaking to the New York State Bankers' Association, whatever I have said is meant to apply to the State institutions of the entire country. I should not wish to give the impression that I am particularly critical of the New York institutions. Quite the contrary, I am very glad to have this opportunity of testifying publicly to the spirit of good citizenship that you have manifested in every phase of the development of the system from the very first beginnings, when we were dealing with the gold and cotton funds in the fall of 1914. In the negotiations, resulting in the creation of these two funds, there asserted itself for the first time in our financial history a broad national spirit uniting in a work of patriotic co-operation national banks, State banks and trust companies of every section of the country. That was the first effect of the coming of the Federal Reserve

System, the physical organization of which at that time had not even been completed. It is this same spirit, this larger conception of banking functions and ideals, that will ultimately lead into the Federal Reserve System all elements worth having; that is, all elements of financial and moral strength.

I trust that my frankness will not be misunderstood by you. There is an old adage that "imitation is the sincerest form of flattery." I venture to paraphrase this saying into: "frankness is the sincerest form of flattery," because it shows that you respect the intelligence and moral fibre of your audience.

Summary and conclusion

I believe that our future looms large beyond measure;

I believe it our duty to be financially prepared on the broadest possible scale;

I believe that we should use the months ahead of us, not to expand any further, but rather to consolidate our strength;

I believe that, through the Federal Reserve Banks, we should strengthen our hold on the gold in circulation and that the stronger the gold holdings of these banks, the better shall we be equipped to cope with the problems ahead of us, of helping ourselves and of helping the world;

I believe it to be the duty of every bank in the country to contribute its share in equipping our nation for this task;

I believe that State institutions which are strong enough should come in now and do their share, no matter whether or not they are in full accord with every detail of the Federal Reserve machinery;